Docket:	:	A. 06-01-004
Exhibit Number	:	
Commissioner	:	John Bohn
Admin. Law Judge	:	Hallie Yacknin
ORA Project Mgr.	:	Hani Moussa
	:	

OFFICE OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

Office of Ratepayer Advocates Report On the Cost of Capital For Park Water Company

San Francisco, California
April 17, 2006

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CHAPTER 1: INTRODCUTION AND SUMMARY OF RECOMMENDATIONS

This report contains the recommendations of the Division of Ratepayer Advocates (DRA) regarding the estimated average rate of return for the years 2007 through 2009 for Park Water Company (Park Water) in connection to A. 06-01-004. DRA recommends a rate of return (ROR) for Park Water of 9.09% for Test Year 2007 and the attrition years 2008-2009. This return compares to the ROR requested by Park Water of 9.82% for 2007 through 2009. As reflected in Table 1-1, DRA recommends 10.14% for the return on equity (ROE); this recommended ROE includes a 30 basis point size risk premium. Park Water is requesting 11.50% for its ROE. For debt, ORA accepts Park Water's requested cost of debt which consists of 7.87% for the years 2007 through 2009 respectively. See Table 1-1 for a comparison of the company's requested and DRA's recommended rate of return and capital structure.

			Table 1 -1					
			Park Water Company					
		Comparison of Requested and ORA Recommended						
			Cost of Capital & Capital Structure					
			Cost of Capital 2007 thru 2009					
		Park Water Company Requested:				ORA Recommended:		
		Capital	Cost	Weighted		Capital	Cost	Weighted
		Structure	Factor:	Cost:		Structure	Factor:	Cost:
2007								
Long Term Debt		46.25%	7.87%	3.64%		46.25%	7.87%	3.64%
Common Equity		53.75%	11.50%	6.18%		53.75%	10.14%	5.45%
Total		100.00%		9.82%		100.00%		9.09%
2008								
Long Term Debt		46.25%	7.87%	3.64%		46.25%	7.87%	3.64%
Common Equity		53.75%	11.50%	6.18%		53.75%	10.14%	5.45%
Total		100.00%		9.82%		100.00%		9.09%
'2009								
Long Term Debt		46.25%	7.87%	3.64%		46.25%	7.87%	3.64%
Common Equity		53.75%	11.50%	6.18%		53.75%	10.14%	5.45%
Total		100.00%		9.82%		100.00%		9.09%

CHAPTER 2: QUANTATIVE ANALYSIS

A. INTRODUCTION

The market's required return on equity is not directly observable. Implicit in stock prices, however, is investors' expected returns. Analytical techniques based on finance theory have been developed to infer the return on equity from stock – price data. DRA uses two financial models – Discounted Cash Flow (DCF) and Risk Premium (RP) – to estimate investors' expected ROE for Park Water Company (Park Water). The Tables referred to in this chapter are located at the end of the chapter.

B. DISCUSSION

1) Comparable Group

DRA has determined a range of ROE's for Park Water by applying the DCF and RP Models to a group of comparable water utilities. Results derived from the DCF may be biased and less reliable when applied to a specific company, such as one with unusually high or unusually low dividend growth rates. Applying the DCF and RP Models to a larger sample, such as DRA's comparable group, serves to correct such biases. ORA chose six utilities as the comparable group using the following criteria: (1) water operations that account for at least 70% of the utility's revenues and (2) the utility's stock is publicly traded. See Table 2-1.

On occasion, some water utilities have rebutted the use of staff's data and models by taking individual components out of context to supposedly illustrate that staff's results are not reasonable. Since staff bases its recommended ROE on an average of results using various components (all described in the following

discussions) taking an individual component and calculating the models in such a "vacuum" is incorrect and proves nothing. This 'recalculation" of staff's data is improper and cannot be applied to the results calculated in this report.

2) Discounted Cash Flow Model (DCF)

The DCF Model reflects the current market price of a share of common stock equal to the present value of the expected future stream of dividends and the future sale price of a share of stock, discounted at the investor's discount rate. The expected rate of return is expressed by the discount rate that equates the market price of the stock to the present values of the flow of cash receipts. The DCF Model solves for the investor's discount rate as follows:

$$R = D1/Po + g,$$

Where:

R = the investor's expected return on equity,

D1 = the expected dividend in the next period,

Po = the market price in the current period, and

g = the expected future dividend growth rate.

3) Dividend Yield

The dividend yield depends on next year's dividends per share and the current stock price. The next year's expected dividend yield, D1 / Po, can be estimated by multiplying the current dividend yield, Do/Po, by one plus the expected growth rate ***"g"***. DRA has also adjusted the dividends to account for quarterly compounding; in order to account for the time value of money. DRA used the 90 day commercial paper rate of 4.90% (March/2006) to account for the future value of these quarterly dividends.

Table 2-2 shows the current annualized dividend yield for the comparable group. The average yield is 2.90% over the most recent three month period of December of 2005 to February 2006, 2.87% for the most recent six-month period of September of 2005 through February of 2006, and 2.88% for the most recent 12-month period of March of 2005 through February of 2006. Three different periods are used in order to mitigate period specific biases and to consider both current and long-term trends.

4) Growth Rates

The DCF Model assumes that dividends grow at a constant rate, g, and continue growing at that rate for the foreseeable future. In order to balance the historical and forecasted growth rates, DRA examined three types of growth rates to estimate future dividend growth: (1) historical dividend and earnings growth rates, (2) sustainable growth rates, and (3) a forecast of earnings growth rates for the comparable group of companies.

5) Historical Growth Rates

(a) Earnings and Dividend Growth

Historical Growth rates can provide a useful indication about future growth when past conditions can be reasonably expected to continue. Table 2-3 shows the average historical earnings and dividend growth rates of the comparable group for the period 1994 through 2005, with both five and ten year averages. Even though dividend per share growth is preferable, since an exact correlation can be made to other components in the DCF Model (dividends are part of the dividend yield calculation), earnings are necessary to generate dividends, so earnings growth is also included in this analysis**.**

Concerns have been raised in other cases that the historical growth rates used by DRA are not similar to those being forecasted. Therefore the historical growth rates are not indicative of future growth. One only has to look at the historical

average earnings growth rates listed on Table 2-3 to see that the forecasted average earnings on Table 2-4 are within a relative range. If one was to look at DRA's work papers that support Table 2-3, one would see even more individual company historical growth rates that are within the range of forecasted growth rates and higher.

The average historical five and ten year earnings growth rates are 9.12% and 6.29%. The average historical five and ten year dividend growth rates are 2.91% and 2.64%.

6) Sustainable Growth

The expected future growth rate can also be measured by examining the sustainable growth rate, which is equal to the product of the retention ratio and the book return on equity. Growth in earnings and, dividends can only be sustained if a portion of the earnings is reinvested by the company. DRA calculates sustainable growth per the method discussed in the The Cost of Capital – Estimating the Rate of Return for Public Utilities,[1] which states that sustainable growth is measured as "The rate of return on book equity, ROE, times the proportion of earnings that is retained within the firm, …instead of being paid out as dividends…The sustainable growth rate, …was calculated by multiplying the five-year average book return on equity by the earnings retention rate (the retention rate is one minus the dividend payout rate)."[2] In the above referenced book, the authors also discuss the possible use of issuance cost in the

[1] The Cost of Capital-Estimating the Rate of Return for Public Utilities, by A. Lawrence Kolbe and James A. Read Jr., with George R. Hall, 1985.

[2] Ibid.,pages 55 and 99.

determination of the return on equity. This is not included by DRA because in D. 92-11-047, this Commission rejected the use of issuance cost in the determination of the ROE.[3]

The group's average five-year sustainable growth rate is 2.90% and the ten-year sustainable growth rate is 2.71% (Table 2-3).

7) Overall Historical Growth

Based on the average historical earnings, dividend, and sustainable growth rates, the overall average historical growth is 4.43%.

8) Forecasted Growth Rates

DRA also considered several forecasted earnings growth rates, including Zack's, First Call (for this case it wasn't available), S&P (for this case it wasn't available), Valueline, and Multex, as shown on Table 2-4. DRA took a weighted average of the forecasts, based on the number of companies for which each organization provides a forecast.[4] This overall weighted average is 7.86%.

[3] "the drop in the market price upon a new issuance may be only temporary and be erased by a subsequent price rise and that, in practice, some new issuance's cause price rise" (D.92-11-047, p.85). "floatation adjustment is inappropriate as long as utility stocks are trading significantly above their book value" (D.92-11-947, p. 86).

[4] DRA weights the average of each forecaster by taking the number of its data points, dividing by the total number of data points, and then multiplying this by the average. This operation is performed for each column, then totaled to determine the overall weighted average of the forecasts.

9) Conclusion – Growth Rate

Based upon the above discussion, DRA has determined an average growth rate of 6.15%.[5]

10) Results of DCF Model

The results of the DCF Model using data from the comparable group are summarized in Table 2-5. Based on current dividend yields (Table 2-2) and an expected overall growth rate of 6.15%, the expected three month dividend yield for the comparable group is 2.90%, the expected six month dividend yield is 2.87%, and the expected twelve month dividend yield is 2.88%. Combining the expected three, six, and twelve month yields with the expected growth rates produces expected returns on equity of 9.23%, 9.20%, and 9.21%, with an average of 9.21%. (See Table 2-8)

11) Risk Premium Model (RP)

The Risk Premium Model recognizes that investors have different requirements regarding risk and return for common stocks as compared to bonds. The RP equation is written as follows:

$$\mathbf{Kt = kd + RP},$$

Where Kt is the cost of equity, kd is the cost of debt, and RP is the Risk Premium.

This model is based upon the assumption that investments in common stock are riskier than investments in long – term debt, since stockholders are but residual claimants to earnings and assets in the event of liquidation. As a result, investors

[5] Average of the Average Historical Growth rate of 4.43% and Average Forecast Growth Rate of 7.86% results in an average growth rate of 6.15%.

holding common stock expect higher returns. In order to develop the required return on equity, this greater risk is stated as a premium, which is added to the estimated cost of long-term debt. As a result of the variance in historical premiums, an average risk premium is calculated over an extended period of time, five and ten years in this case.

DRA applied the RP Model to the same comparable group used in the DCF model in order to determine the appropriate return on equity for Park Water. DRA used historical earned ROE's for the comparable group in order to estimate the stockholder's expected return on equity. These returns are easily accessible to the investor (annual reports and financial web sites) and require no computation. An alternative is to use the authorized ROE, but this has not been considered by DRA, because authorized ROE is not always an accurate measure of what is expected by investors. The authorized ROE can be distorted by the effect of settlements (the ROE could be inflated, or deflated to account for trade-offs in other areas of a settlement). The annual yields on 10 – year and 30 – year Treasury bonds were subtracted from the comparable group's average returns on equity for each year to determine the annual risk premium.

(a) Results of Risk Premium Model

Table 2-6 presents forecasted interest rates for the test period, taken from Data Resources Inc. (DRI) report for March 2006. DRI has consistently been accepted by this Commission for use in determining a cost of capital.[6] For the period of 2007 to 2009, the average forecasted rate for 10 – Year Treasury bonds is 5.20%, and the average forecasted rate for 30 – Year Treasury bonds is 5.41%.

[6] 38 CPUC 2nd at page 238 and 46 CPUC 2nd at pages 319, 360 – 361.

Table 2-7 provides the results of the Risk Premium Model for DRA's comparable group. The average premiums are 5.34% and 4.90% for the ten-year period and 5.55% and 4.86% for the five-year period, based upon 10-year Treasury bond yield and the 30-year Treasury bond yields, respectively.

To derive interest rate forecasts for the test period. Based on the 10-year premiums, DRA calculated an expected return on equity of 10.54% for the 10-year Treasury bond yield and 10.31% for the 30-year Treasury bond yield. Using the 5 – year risk premiums produced expected returns of 10.75% for the 10-year Treasury bond yield and 10.27% for the 30-year Treasury bond yield. Combining these results, DRA calculated an average ROE of 10.47%. (See Table 2-8).

12) Park Water Company-Capital Structure

Park Water Company has proposed a capital structure consisting of long-term debt, and common stock. Park Water's projected common equity ratio for the years 2007 – 2009 averages 53.75% which is higher than the comparable groups' average of 50.21%. The company's proposed long-term debt ratio for the same period averages 46.25% which is lower than the comparable group average of 49.26%. See Table 2-1. DRA has reviewed Park Water's proposed capital structure and has determined that it is reasonable. See Table 1-1 of this report.

13) Summary of Model Results

Table 2-8 summarizes the results of the DCF and RP Models. The two models used to derive the return on equity indicate a return on equity within the range of 9.21% to 10.47%. Averaging the results of the financial models produces an expected return on equity of 9.84%. This is relatively the same ROE of 9.85% adopted by the Commission recent general rate case (GRC) for Park's Apple Valley Ranchos District. In this case the Commission states:

> "We will adopt the corrected ORA recommendation, inclusive of the risk premium, because the 10.15% return on equity (9.85% + 0.30%) most reasonably reflects the risks faced by Apple Valley."[7]

The Commission also adopted in Park's Central's District last GRC a 30 basis point adder to the adopted ROE. Accordingly, DRA has added a 30 basis point size risk premium per reasons stated per D.99-03-032 and D.05-12-020 that results in an overall expected return on equity of 10.14%. In Chapter 3 of this report, DRA discusses in more detail the reasons for continuing to limited Park Water's risk premium to 30 basis points.

[7] D.05-12-020, mimeo, p. 14.

					Table 2 - 1		
			Park Water Service				
			Summary of Equity and Long-Term Debt Ratios				
			For ORA's Comparable Group of Companies				
Companies:			Equity Ratio:		Debt Ratio:		
American States Water			48.00%		52.00%		
California Water Service Co. /			51.06%		48.40%		
Connecticut Water Service			57.00%		43.00%		
Middlesex Water Service /1			44.00%		53.77%		
Philidelphia (Aqua American)			47.20%		52.80%		
San Jose Water			54.00%		45.60%		
Comparable Group Average:			50.21%		49.26%		
Park Water Service Co. Average Equity and Debt							
Ratio for 2007 thru 2009:			**53.75%**		**46.25%**		
1/ Has Preferred Stock							

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			Table 2-2					
			Park Water Service Company					
			Current Annualized Dividend Yield					
			Comparable Group					
			3-Month		**6-Month**		**12-Month**	
			Dividend		**Dividend**		**Dividend**	
			Yield		**Yield**		**Yield**	
American States Water			2.89%		2.92%		3.09%	
Californinia Water Service			3.50%		3.48%		3.09%	
Connecticut Water Service			3.55%		3.53%		3.52%	
Middlesex Water Service			3.73%		3.52%		3.53%	
Philadelphia Suburban			1.50%		1.52%		1.71%	
San Jose Water			2.20%		2.24%		2.36%	
Average			**2.90%**		**2.87%**		**2.88%**	
Current Yield = Do/Po								

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Table 2 - 3

Average Historical 5 & 10 Year Growth Rates

Comparable Group

1996 - 2005

Year's	Earnings Growth %	Dividend Growth %	Sustainable Growth %	Overall Average Growth Rate (%)
	xx	xx		
1994	-4.00%	1.90%	1.04%	-0.35%
1995	-1.28%	-5.01%	2.53%	-1.25%
1996	13.82%	3.11%	3.50%	6.81%
1997	4.32%	1.42%	3.81%	3.18%
1998	-3.04%	3.08%	2.95%	1.00%
1999	4.12%	2.70%	2.63%	3.15%
2000	-1.93%	1.50%	1.59%	0.39%
2001	19.77%	2.70%	2.65%	8.37%
2002	7.15%	3.01%	3.01%	4.39%
2003	-4.36%	3.21%	2.79%	0.55%
2004	18.26%	2.87%	3.27%	8.13%
2005	4.76%	2.76%	2.78%	3.43%
5 Year Averag	9.12%	2.91%	2.90%	4.98%
10 Year Avera	6.29%	2.64%	2.71%	3.88%
Overall Average Growth Rate:				4.43%

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		Table 2-4				
		Park Water Company				
		Comparable Group Forecasted Earnings				
		Growth Rates				
	First					
	ZACK'S	Call	S&P	Valueline	Reuters	
Date of Data Drawn:	4/06	Not Avail	Not Avail	1/06	'4/06	
Company						
	%	%	%	%	%	
American States Water Co.	6.00%	N/A	N/A	12.00%	4.50%	
California Water Service	9.00%	N/A	N/A	8.50%	9.00%	
Connecticut Water Service	N/A	N/A	N/A	N/A	N/A	
Middlesex Water	3.50%	N/A	N/A	N/A	3.50%	
Philadelphia Suburban	9.00%	N/A	N/A	13.00%	8.42%	
SJW Corp.	N/A	N/A	N/A	N/A	N/A	
Average:	6.88%	N/A	N/A	11.17%	6.36%	
Overall Weighted Average						
of Forecasted Growth Rate	2.50%	0.00%	0.00%	3.05%	2.31%	
Total Overall						
Weighted Average						
of Forecasted Growth Rates:		7.86%				
-						
TOTAL OVERALL AVERAGE GROWTH RATE EQUALS: 6.15%						
	-					

Table 2-5	
Park Water Service	
Discounted Cash Flow Model Summary	
for the Comparable Group	
Component:	
3 - Month Current Yield 1/	2.90%
Growth Rate 2/	6.15%
Expected Yield 3/	3.08%
ROE 4/	9.23%
6 - Month Current Yield 1/	2.87%
Growth Rate 2/	6.15%
Expected Yield 3/	3.05%
ROE 4/	9.20%
12 - Month Current Yield 1/	2.88%
Growth Rate 2/	6.15%
Expected Yield 3/	3.06%
ROE 4/	9.21%
1/ Current Yield = Do/Po	
2/ Growth Rate = G '(Table's 2-3 & 2-4)	
3/ Expected Yield = D1/Po = Do/Po ' (1 + G)	
4/ ROE = D1/Po + G	

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				Table 2-6					
				Park Water Service					
				Forecast of Interest Rates - Average Year					
								Average	
			Forecast	Forecast	Forecast	Forecast		for	
			Date:	'2007	2008	2009		2007-2009	
	Description:			%	%	%		%	
30 - year Treasury Bonds			DRI - 3/06	5.09%	5.37%	5.76%		**5.41%**	
10 Year Treasury Notes			DRI - 3/06	4.97%	5.13%	5.50%		**5.20%**	

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			Table 2-7		
			Park Water Service		
			Risk Premium Analysis		
			Comparable Group		
	Return				
Year	on	Average Yearly Yiel		Risk Premium	
	Equity1/	30-Year	10 - Year	30 - Year	10 - Year
	%	T - Bond	T - Bond	T - Bond	T - Bond
		%	%	%	%
1993	11.57%	6.60%	5.87%	4.97%	5.70%
1994	10.90%	7.35%	7.09%	3.55%	3.81%
1995	11.17%	6.88%	6.57%	4.29%	4.60%
1996	11.93%	6.70%	6.44%	5.23%	5.49%
1997	11.72%	6.61%	6.35%	5.11%	5.37%
1998	10.87%	5.58%	5.26%	5.29%	5.61%
1999	10.88%	5.87%	5.64%	5.01%	5.24%
2000	9.95%	5.94%	6.03%	4.01%	3.92%
2001	10.53%	5.49%	5.02%	5.04%	5.51%
2002	10.52%	5.42%	4.61%	5.10%	5.91%
2003	9.54%	5.05%	4.02%	4.49%	5.52%
2004	9.75%	5.12%	4.27%	4.63%	5.48%
2005	9.62%	4.56%	4.29%	5.06%	5.33%
	10 - Year Average Risk Premium			4.90%	5.34%
	5 - Year Average Risk Premium			4.86%	5.55%
MARCH DRI '06					
Forecasted Interest Rates for 2007-2009				5.41%	5.20%
Projected Returns on Equity				30 - Year	10 - Year
	10 Year Average:			10.31%	10.54%
	5 Year Average:			10.27%	10.75%

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		Table 2 - 8		
		Park Water Service		
		Summary of Model Results		
		Comparable Group		
Discounted Cash Flow Model				
Growth Rate		6.15%		
Three Month ROE		9.23%		
Six-Month ROE		9.20%		
Twelve - Month ROE		9.21%		
DCF Average		9.21%		
Risk Premium Model				
		5 - Year	10 - Year	
30 - Year Treasury B		10.27%	10.31%	
10 - Year Treasury B		10.75%	10.54%	
Risk Premium Avera		10.51%	10.43%	
Overall RP Average		10.47%		
Return on Equity Av		9.84%		
-				
PLUS 30 BASIS POINTS = 10.14%				
-				

CHAPTER 3: FINANCIAL AND BUSINESS RISK

A. INTRODUCTION

In Chapter 2 of this report, DRA determined that the typical common equity investor expects an annual earned return of 9.84%. This determination is the result of a quantitative analysis using market – based financial data from a group of comparable water companies of comparable risk. In addition to this quantitative analysis, DRA assesses the level of business and financial risk faced by Park Water. Based on the financial and business risk information reviewed, at this time, DRA believes that Park Water should receive no more than a 30 basis risk premium above the recommended ROE of 9.84%. DRA recommendation is consistent with previous GRC decisions for Park Water's Apple Valley Ranchos and Central districts.

A company's total risk is the combination of business risk and financial risk. Business risk may be defined as the uncertainty inherent in the projections of future operating income relating to the fundamental nature of the company's business. Given the nature of the industry, the business risk of a regulated utility consists primarily of regulatory risk. Financial risk relates to the amount of debt in the capital structure; the larger the debt portion, the greater the financial risk.

B. DISCUSSION

1) Regulatory Risk

The number of regulatory mechanisms provided by the Commission virtually eliminates regulatory risks to Park Water. These include Balancing accounts for the Purchased Water, Purchased Power, and Pump Taxes; Memorandum Accounts for Catastrophic Events, and Waste Contamination; Memorandum Accounts for

SDWA compliance; 50% Fixed Cost Recovery; and Construction Work in Progress in Rate Base.

Park's regulatory and business risk has been reduced as a result of the elimination of the earnings test. The Commission has recently eliminated the earnings test for the recovery of the water supply balancing account under collections.[8] The elimination of the earnings test will allow water utilities to recover the full amount of the under collected balance regardless of the level of utility earnings above the Commission authorized rate of return. The removal of the earnings test will now allow the water utilities to further enhance profits and basically eliminate their regulatory risk associated with the recovery of water supply costs.

Park has requested in its GRC for Central that it be granted a Water Revenue Adjustment Mechanism similar to that requested by the Cal-Water Service Company. For reasons discussed in DRA's Chapter 12, Park's Central District Results of Operations Report, DRA is recommending Park's request for a WRAM balancing account be denied. However, DRA notes that if the Commission were to consider granting a WRAM account for Park, it would basically insulate the company from fluctuations of its authorized sales revenues. At present, water utilities sales revenues are at risk for water consumption changes due to weather seasonality, and any reductions in consumption due to conservation. Today and in the past water utilities have implicitly been compensated for this business risk in the adopted ROE. Therefore, when granting a WRAM the Commission must consider reducing a water utility's ROE, because the WRAM will further insulate water utilities from the business risk associated

[8] D.06-04-037, mimeo, p. 2.

with sales fluctuations. In the Cal-Water general rate case, this issue has been litigated and it is pending a Commission decision. DRA has recommended that Cal-Water's ROE be reduced by 300 basis points. At a minimum, the Commission should remover the 30 basis risk premium if, at a alter date, it grants Park Water's request for a WRAM balancing account.

2) Financial Risk

Financial risk relates to the amount of debt used in the capital structure. The greater the ratio of debt to equity, the greater the financial risk. For regulated utilities, the percentage of debt and equity included in the capital structure has a direct impact on rates charged to ratepayers. A balanced capital structure has a positive impact on rates charged to ratepayers. A balanced capital structure should provide financial stability to a utility and produce reasonable rates for its customers, as well as continuity of service.

Park Water Company has proposed a capital structure consisting of long-term debt, and common stock. Park Water's projected common equity ratio for the years 2007 – 2009 averages 53.75%, which is slightly higher than the comparable groups' average of 50.21%. Park Water's projected long term debt ratio for the years 2007 – 2009 averages 46.25%, which is lower than the comparable group average of 49.26%; which would support the assertion that Park Water has lower financial risk than the comparable group of water utilities. See Table 2-1. Because Park Water isn't leveraged as highly as the average class "A" water utility; may indicate that it isn't entitled to receive some level of risk premium for its cost of equity. The company has requested to receive a 70 basis point size risk premium on its cost of equity, based on allegations that it is more risky than the larger Class water utilities. DRA has included a 30 basis point size risk premium in its DCF, and RP results, because the commission has awarded Park a 30 basis point size risk premium in Decisions D.05-12-020 and 99-03-032. Park Water's made the same allegations in its recent Apple Valley Ranchos (AVR) rate case,

where the Commission dismissed the company's request for a 90 basis point risk premium adder to the company's ROE. In Park Water's AVR GRC, the Commission found that the equity returns presented by the company models were inflated.[9] It also found, that certain asserted risks to support its high risk premium are in fact discretionary choices made by Park, the parent company that exercises complete control over AVR.[10] The parent company similarly exercises the same control over Park Water's Central district. Thus, recent findings by the Commission continue to dismiss Park Warter's request for a significant increase above the currently authorized 30 basis points risk premium.

3) Standard and Poor's Assessment

A company's total risk (business risk plus financial risk) is indicative of its overall financial integrity and ability to attract capital. Standard & Poor's (S&P, a rating agency), evaluates a company's total risk in order to assign a credit rating, which is a direct measure of capital attraction. S&P's evaluation includes a subjective analysis of business risk, including such things as managerial quality and regulatory environment. A quantitative analysis is also done, consisting of a group of financial ratios designed to measure how well a company can generate earnings and cash flow to meet its debt obligations. These ratios are a mix of measures relating to both business and financial risk. A rating of "AAA" through a "BBB" is considered "investment grade". Any rating lower than a "BBB" is considered speculative and more susceptible to adverse circumstances, or economic conditions. Based upon the data contained in table 10 – M; the company's 5 year average pretax interest coverage of 2.36 puts the company in the "BBB" range. On the other hand the company's 5 year average debt to equity ratio puts them in the "A" range based upon Standard & Poor's risk measurements.

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[9] D.05-12-020, mimeo, pp. 10-11.

[10] Ibid, p. 11.

S&P hasn't rated Park Water's long term debt in part, because the company's stock isn't publicly traded. However, this fact has not impaired the company's ability to issue long term debt at favorable rates. For example, the company's weighted average cost of debt is 7.87% which is comparable to the cost of other large utilities.

C. CONCLUSION

Park Water appears to have relatively low business risk, but higher financial risk because of its inability to sell equity securities over the counter. The company does possess a reasonable amount long-term debt in its capital structure.

CHAPTER 4: COMMENTS ON PARK WATER COMPANY'SMETHDOLOGY

A. INTRODUCTION

Park Water has presented various models in support of its requested ROE of 11.50%, in addition to the issues listed below. DRA does not agree with the following components of Park Water's analysis:

1. Increased Construction Expenditures,
2. Comparison to Gas Utilities,
3. Effect of Proposed Change in Balancing Account Recovery

B DISCUSSION

1) Increased Construction Expenditures

Park Water is concerned that it must replace contaminated water supply sources with no assurance of recovering the cost to make those replacements. The company may have to invest in new treatment facilities to treat groundwater contamination; increasing the risk that it faces.[11] If investment in these facilities is determined to be reasonable by this Commission, the capital projects will be included in rate base and Park Water will receive a return on its investment. If these additions are determined not be reasonable by this Commission, ratepayers shouldn't be burdened with either the cost of the addition, or any risk due to non-recovery of the investment.

[11] A. 06-01-004, pages. 32

2) Comparable Group Selection

Park Water uses a comparable group of water and gas utilities for its DCF, Risk Premium, and CAPM models. The DCF, Risk Premium, and CAPM models are used to estimate the company's ROE.

(a) Comparison to Gas Companies

The Commission has stated that water utilities should not be compared to companies in other industries (D.01-04-034, p.13-14; D.90-02-042, p.38). Other regulated utilities may appear to have similar characteristics to water, but are not in fact comparable. In D.92-01-025, p.23, the Commission stated, "Due to the revenue recovery mechanisms in place for water utilities, we find that water utilities do not face the same overall risks as energy and telecommunications utilities." The Commission recently dismissed Park Water assertions regarding comparability to the gas industry. In D.05-12-020, the Commission states:

> "We also find that natural gas rates of return are not relevant for Apple Valley. The cost recovery and market risks are totally dissimilar. Apple Valley failed to provide any convincing evidence to support the relevance of gas utility returns, and thus it failed to meet its burden of proof on this portion of its cost of capital showing. We therefore reject Apple Valley's presentation on the returns of equity applicable to gas utilities, while noting that Apple Valley does not base its request on this study." (D.05-12-020, p. 11.)

Accordingly, consistent with recent and post decisions, the Commission should reject Park Water's use of gas utilities as a proxy group to establish its ROE.

3) Effect of Proposed Change in Balancing Account Recovery

At page 32 of Park Water's application; the company raises the concern that the change in balancing account recovery (D. 03-06-072) will increase the risk it faces, by impairing its ability to earn its authorized ROR. Surprisingly, Park Water's ROE witness does not note that there was a pending decision before the Commission to eliminate the earnings test on balancing account recovery for under collections.

The Commission issued decisions which address balancing account dollars recorded prior to November 29, 2001; see (D.02-12-055), as well as procedures for recovery of balancing account dollars recorded subsequent to November 29, 2001: see (D. 03-06-072). The first decision ordered that all balancing account dollars existing prior to November 29, 2001 may be recovered by the water utilities, therefore eliminating some of the so called risk of impairing the company's ability to earn its authorized ROR as claimed by Park Water. The second decision adopted revised procedures for recovering dollars from balancing accounts. In the determining the level of recovery for the under collection of water utility balancing accounts, the application of the earnings test is essential to prevent water utilities gaining any windfall when its returns already equal or exceed the Commission's authorized rate of return. However with the recent elimination of the balancing account earnings test, significantly increase the opportunity for water utilities to maximize profits and have a greater opportunity to meet or exceed their authorized rate of return.

CHAPTER 5: COST OF LONG TERM DEBT

A. DETERMINATION OF LONG-TERM DEBT COST

The cost of long-term debt consists of interest and issuance expenses for all long-term bonds and notes, both outstanding and projected for the test period. The majority of the cost is derived from embedded costs, with the balance consisting of estimated cost for projected new issues. Since debt is a contractual arrangement, the terms for existing bonds are known. The costs of new debt issues are dependent, however, on forecasts of interest rates. The effective cost of long-term debt is computed as the ratio of the annual charge for the balance outstanding divided by the net proceeds of the balance outstanding.

B. SUMMARY OF RECOMMENDATIONS

DRA, has reviewed Park Water's application, and work paper's which outlined in detail the company's cost of long – term debt, and found the company's numbers to be reasonable. Park Water has indicated that it will be issuing $15 million in new debt in 2006.[12] The company has requested an overall cost of debt of 7.87% for the years 2007 through 2009. See Chapter 1, Table 1-1 of this report.

[12] See D.06-01-019.

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QUALIFICATIONS AND PREPARED TESTIMONY
OF
CLEASON WILLIS

Q.1. Please state your name and business address.

A.1. My name is Cleason Willis. My business address is 505 Van Ness Avenue, San Francisco, California, 94102.

Q. 2. By whom are you employed and in what capacity?

A. 2. I am employed by the California Public Utilities Commission as a Regulatory Analyst.

Q. 3. Please briefly describe your educational background and work experience.

A. 3. I graduated from the California State University of Hayward with a Bachelor of Science Degree in Business Administration and Finance, and a Master of Science Degree, in Public Administration, and Management.

I have been employed by the CPUC since 1987. From 1987 through 1989, I was a member of the Special Economics and Research Branch, where I participated in several general rate case analyses of major electrical utilities. I also constructed an Elfin Financial Model, which was used to forecast a utility's capital structure, cost of capital, and revenue requirement. From 1989 through 1992 I worked in the Financial Auditing Branch where I performed various types of audits of major electrical utilities. From 1992 through 1994 I was assigned to the Telecommunications Branch where I had the opportunity to work on Monitoring Reports, and 851 review of mergers. In 1995 through 2000 I was member of the Financial Analysis and Investigations Branch, where I worked on various rate case proceedings that ranged from General Rate Case proceedings to Balancing Account proceedings. From 2001 through the present I have been assigned to the Water Branch of ORA (The Office of Ratepayer Advocates), where I have

participated in various Gas rate proceedings, as well as marginal cost studies. Since 2002 I've been assigned to ORA's Water Branch, where I have performed cost of capital studies for class A water utilities.

Q. 4. What is your area of responsibility in this proceeding?

A. 4. I am responsible for Cost of Capital report for the Park Water Company GRC.

Q. 5. Does this conclude your prepared testimony?

A. 5. Yes, it does.